Dummy auction bids

The adverse effect of dummy auction bids on market value

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Abstract

The popularity of an auction as a means of selling residential real estate has increased markedly in recent years. The effectiveness of an auction program is heavily promoted by most real estate agents, claiming it to be the best means of attracting the best price from the highest bidder. It is based on the theory of gathering all buyers together at a publicised time, and then offering the property for sale to the open market.

In theory, the person most willing to buy the property will have the highest bid, supposedly agreeing at market value with the vendor (although above the vendor's reserve). Unfortunately, the practice of dummy bidding has recently resurfaced and highlights serious flaws in the auction system, with hundreds of residential auctions conducted across Australia every weekend.

Clearly, it is in the vendor's best interests (and the auctioneer's best interests, who is paid even more by the vendor if the price is higher) to achieve the highest offer from the last bidder. The tactic of dummy bids is designed to deceive genuine purchasers into a false sense of perception, where there appears to be more competition for the property than there actually exists.

This paper examines the auction process with the emphasis placed on the practice of dummy bidding. It considers the broad implications for the definition of market value and also the overall residential market. Useful advice is also included for real estate valuers relying upon auction sale properties in their market analysis. As well as strongly supporting the auction concept, the authors suggest improvements to the overall auction process to ensure relevance to the definition of market value is maintained.

Introduction

When called upon to investigate the circumstances surrounding a sale, an auction has been typically welcomed by valuers as an arm's length open market sale and a viable way to successfully complete real estate exchanges (Sherman & Bussio, 1994).

The definition of market value for real estate remains the focus of all real estate valuation reports, and can be restated as 'the estimated amount an asset should exchange for on the date of valuation between a willing buyer and willing seller on the date of valuation after proper marketing, wherein the parties acted knowledgeably, prudently and without compulsion' (IVSC, 2001).

The auction process overcomes many of the problems that can be associated with this definition of market value. For example, a typical marketing period before an auction is about four weeks and, coupled with an advertising campaign and open inspections, is normally considered an adequate length of exposure for most residential properties.

So long as the auction is well attended by the purchaser public, the final sale price is supposedly set by the market, and not by the vendor (Dotzour, Moorhead & Winkler, 1998). Or is it? In other words, the use of an auction sale has commonly been seen to overcome many of the problems associated with vendor knowledge, or their lack of knowledge about the marketplace. For example, a vendor would rarely inspect other properties for sale in the prevailing market, to the same level of detail as a buyer would.

Therefore, if conducted and marketed properly, an auction protects the interests of the vendor in accordance to the definition of market value. However, in reality, little consideration has been given to the conduct of auctions from the buyer's perspective, and if it really is an arm's length open market sale.

Unfortunately, the practice of dummy bids has again resurfaced in Melbourne, with little evidence to suggest it has ever disappeared completely. At times, dummy bidding is also referred to as vendor bidding, and has been part of the Melbourne real estate scene for 30 years (Bruce Bell as cited by Money, 2002). This technique could cause the buyer to pay an additional amount to buy the property over and above the true market value, at times competing with a bidder who is acting on behalf of the auctioneer and has no intention of actually buying the property.

Background

The residential real estate market in Melbourne is commonly referred to as the auction capital of Australia. If not the world. It has been estimated that approximately 75 per cent of residential properties in Melbourne are sold through a planned auction program, including a successful offer before, during and after the auction date (Kenman, 2002).

The balance is sold by private treaty using a for sale price or through a tender process. It is generally accepted in the marketplace that most houses are sold by auction, and the buyer market is well trained to attend advertised open house inspections within the...
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In other words, this case has identified that the relationship between an auctioneer and highest bidder may give rise to a contract. Accordingly, it is an implied term of this contract that the parties would act reasonably, fairly and in accordance with due process. It follows on that a dummy bidder may be breaching this term although is yet to be fully tested in the Australian legal system.

Review of literature

As anticipated, a global literature search revealed either little or no research had been conducted on the effect of dummy bidding on final sale values, obviously because of the difficulties associated with defining and measuring the effects of this secretive, but accepted practice. Previous researchers have studied the auction process, with the emphasis placed on highlighting differences between the final sale price of an auction sale in contrast to the final sale price of an open market sale (or a 'for sale' property advertised as a set asking price). Interesting results were produced for both techniques and are discussed further below.

The overall trend indicates that an auction of a residential property would produce a higher transfer price than if a conventional open market sale process was used. Previous studies conducted in Australia suggested a premium of about three per cent up to as much 15 per cent (Lusht, 1990) (Newell, Macfarlane, Lusht & Bulloch, 1993, as cited by Dotzour et al., 1998). A Melbourne study using house sales data from 1988 and 1989 concluded that a vendor would achieve an additional 5.5 per cent by auctioning rather than selling (Lusht, 1990).

However, there were no valid reasons offered to explain this premium. "While differences in market conditions can explain variations in the auction discount, they cannot explain why auctioned property should ever sell at a premium" (Lusht, 1996 as cited by Mayer, 1998, p.42). While an auction conducted under must sell circumstances (e.g. mortgagee in possession) would place downward pressure on the final sale price, a higher sale price produced by an auction requires additional analysis.

It has been argued that an auction benefits the real estate industry and the buyer at an auction process (Mayer, 1989 as cited by Dotzour et al., 1998), with seemingly little control over the auction proceedings and the bidding process. This may be true in some respects, and could encourage the use of tactics such as dummy bidding to inflate the price. Seemingly impossible to measure, perhaps the extent of dummy bidding at auctions is more prevalent than estimated.

Dummy bids in the auction process

Often considered a common practice in residential auctions, the use of a dummy bidder has received increasing attention in recent times. However, employing this tactic can have an adverse affect on the mechanics of the auction process and the final sale price.

This technique may involve the prior agreement of a bidder attempting the auction, being a trusted friend or associate of either the vendor or auctioneer. During the auction this person is actively involved in the bidding process and the auctioneer accepts these false bids are a genuine effort to successfully buy the property.

However, the dummy bidder has no intention whatsoever of actually buying the property, fully intending to withdraw from the bidding process before the final bid is given. If the dummy bidder is unexpectedly the last bidder, the auctioneer has the publicised right not to accept that bid, and can take the bid from the second highest bidder.

Overall, there are three main tactics employed by a dummy bidder. These are:

1. To start the bidding at a higher opening bid

It is common knowledge that a group of buyers will run out of steam if the opening bid is too low, as prices tend to increase as the auction progresses (Allen & Swisher, 2000). If relatively small monetary increments are used (as dictated by the bidders, where the auctioneer is reluctant to discount any bid), it may take too long for the bidders to reach the reserve. In each buyer's mind remains the thought that someone viewed this property as only worth a low amount (i.e. the opening bid). However, the role of the dummy bidder in this tactic is to start with a high bid, positioned just below the reserve. This may give the false impression that the property is worth more (rather than less), and gets the bidding process off to
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A competitive start.

2. Actively compete in the bidding process to reach reserve

Unless the bidding reaches the reserve price (set by the vendor), the house will probably not sell at the auction. Therefore, the dummy bidder has a set monetary amount to bid up to, but not exceed. This tactic is successfully employed if there is only one serious bidder at the auction, who would be wise to bid against their own bid. The dummy bidder will push the serious purchaser up to the reserve price, and then withdraw. If there is no serious competition and the reserve price is not achieved, the auctioneer passes in the property and it remains unsold. The dummy bidder then has the first right of refusal, although the target buyers for salespeople in this example would be the second highest bidder. The salespeople from the real estate agents often then speak to all the bidders individually at the end of the auction, which also covers the genuine bidder who reneges at the last moment before the property reaches the reserve.

3. Actively compete in the bidding process to reach the highest price after meeting reserve

It is only the highly experienced dummy bidders who are able to master this skill, and not end up over-cooking the sale. Although the goal for the genuine bidder is to have the highest, last and therefore successful bid, they have competed in the bidding process with the dummy bidder who withdraws from the auction having had the second last live bid.

The above techniques are three of the most common employed by a dummy bidder. The auction process protects their true identity, with only the final successful bidder required to disclose their name. The dummy bidder can melt into the crowd, having created the perception of a false market for the property.

The effect of dummy bidding on market value.

There is little doubt that the general definition of market value, with the emphasis placed on the measure of anxious buyer and anxious seller in the relationship, would be adversely affected by the use of a dummy bidder. Reference to Figure 1 clearly shows the effect that a dummy bidder could have on falsely inflating the fair market value of a property in an auction scenario. The true market value (or worth) should be recorded at point (A), where the property buyer and seller are fully aware of all the circumstances surrounding the sale, including the true state of the market and the actual demand for the property (Sherman et al., 1994).

However, the use of a dummy bidder/deceptively increases the number of buyers in the marketplace, as indicated by (B) in Figure 1. This false market now creates more demand and a higher market value for the property, at times substantially above the true fair market value, shown as new inflated market value (or price) at (C).

In many instances a final successful bidder can be competing with a dummy bidder, and otherwise would not have bid higher against their own bid (if the dummy bidder did not participate in the auction). The end result would be variation between agreed sale price at the auction, and the actual true market worth of the property.

Suggested amendments to the auction process

There are a number of steps that could be taken to remove the deceit caused by dummy bids. Although these suggestions will address some of the problems associated with this practice, the enforcement of these suggestions may prove to be difficult.

Suggestion 1

The auctioneer, vendor and other parties with a financial interest in the sale must declare their relationship with any parties attending the auction. This would ensure the bidders are true arm’s length buyers and do not have hidden interests in the auction process.

Suggestion 2

The legal framework surrounding auctions requires urgent attention to ensure this form of deceit is not continued. This legislation should be enacted using a range of tough fines, including loss of auctioneer’s licence for the proven use of dummy bidders in an auction process.

Suggestion 3

The relevant industry associations continue to actively support the eradication of dummy bidders from auctions by inclusion in their codes of ethics, and enforcement thereof. For example, members found to have violated this code of ethics should be publicly named and heavily fined individually, with a similar action taken against the real estate organisation within which they are employed.

Conclusion

Auctions have always been promoted as a tried and proven method of achieving the highest sale price for a property. It gathers together prospective purchasers in one place at one point in time and sells the property to the highest bidder. The evidence has suggested that auctions generally achieve a higher final transfer price than an open market sale. Even though both approaches are applied in the same marketplace within the definition of market value, there have been no valid reasons to explain this difference.

One practice that has been openly acknowledged is the practice of dummy
bidders, which may partly explain this premium. The use of dummy bidders by the vendor and/or auctioneer could have the effect of distorting the true market value, designed to deceive the purchasing public into competing at an inflated price in the auction process.

It appears that the genuine popularity and reputation of the auction process is seriously threatened by the deceitful use of dummy bidders. Steps must be taken to eradicate this tactic before the entire residential auction industry is discredited, and the level playing field must be returned for the vendor, auctioneer and the bidders alike.

Potential improvements to the auction industry to discourage this practice could include strong fines to both the individual auctioneer and their employer, with endorsement of the fines by the relevant industry body. Not until after the successful eradication of the dummy bid and associated deceitful practices (e.g. two-tier marketing) will buyers and vendors be able to confidently trade in a fair and equitable marketplace. Only then will valuers be able to rely on true market value sales with a higher level of confidence.

Reference List

For some time the Australian Property Institute has been seeking partnerships with external providers that will deliver benefits to Institute members.

The Institute has selected Manchester Unity as its preferred health cover partner. As a member-focused organisation, Manchester Unity was established over 160 years ago and remains one of the best providers of value-for-money health cover in Australia, no matter your life stage.

As a result, the Institute has been able to negotiate extremely competitive rates for members by forming an alliance with Manchester Unity that will deliver:

- special rates for API members;
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- no waiting for benefits that usually require two months' membership*;
- involuntary unemployment and accident insurance;
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- continuity on most benefits when you transfer to the same level of cover from another registered health fund'; and
- extensive private hospital and day surgery contracting throughout Australia.

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If you change your mind and cancel your membership within the first 30 days, Manchester Unity will refund your contributions less any claims made.

For more information on Manchester Unity health cover, contact Ron Svoboda, telephone (02) 6248 8226 or 0417 233 612.

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New health insurance offer for API members